June 18, 2010

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER & EXECUTIVE VICE PRESIDENT

SUBJECT: Management Advisory Report – Civil Service Retirement System Overpayment by the Postal Service (Report Number CI-MA-10-001)

This report presents the results of our review of the Civil Service Retirement System (CSRS) Overpayment by the U.S. Postal Service (Project Number 10YO036CI000). This report discusses the $75 billion CSRS overpayment by the Postal Service in fiscal years (FY) 1972 through 2009. The objective of this review was to assess the facts concerning this overpayment and identify any possible solution(s) to correct the overpayment to the benefit of the Postal Service. This review addresses financial risk. See Appendix A for additional information about this review.

On May 5, 2010, the U.S. Postal Service Office of Inspector General (OIG) entered, for the record, the attached Congressional testimony with the U.S. Congress in addition to the oral testimony previously given by the Postal Service's Inspector General (IG) before Congress on April 15 and 22, 2010.[1] The attached testimony (See Appendix B) explains, in detail, the Postal Service's $75 billion overpayment to the CSRS and three possible solutions to correct the overpayment contained in the IG's written testimony of May 5, 2010. (See Appendix B pages 13 – 16)

Conclusion

The Postal Service pension fund is not made up of tax dollars. The two funding streams are the employees' own money and money collected from postage sales, with inflated prices as a result of the $75 billion overpayment. See Appendix C for OIG's detailed monetary impact calculation. The return of the overpayment or a combination of actions to realize the benefit of the $75 billion overpayment to the Postal Service would fully fund the pension and health retiree plans. The Postal Service's more than $7 billion annual payments for retiree health care prefunding and retiree health care premiums would no

[1] The April 15, 2010, Hearing before the Committee on Oversight and Government reform and the Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia House of Representatives and the April 22, 2010, Hearing before the Senate Homeland Security and Governmental Affairs Committee's Subcommittee on the Federal Financial Management, Government Information, Federal Services, and International Security.

longer be needed, because the pension and health retiree plans would be fully funded and interest income from the fully funded retiree health benefit fund could pay annual premiums. (See Appendix D for details.)

CSRS Overpayment

In July 1971, when the Post Office Department became the Postal Service, employees that belonged to the federal pension fund began contributing to the Postal Service's portion of the pension fund. These retirement costs were divided according to the number of years employees had belonged to each fund. However, the federal pension fund paid for retirements was based on 1971 salaries, not final salaries as administered by the Office of Personnel Management (OPM).

OPM has explained that these mischarges were in response to what they believed to be the will of Congress expressed in 1974 legislation. However, the 1974 language was repealed by Congress in 2003. Congress directed OPM to use its authority to oversee the reforms using accepted "dynamic assumptions" that include pay increases and inflation. OPM switched to dynamic funding for the Postal Service portion, but did not for their share. The Postal Service paid the $75 billion difference.

In 2004, the Postal Service appealed the OPM's methodology for pension fund allocation and the appeal was denied by the OPM. The denial relied on 1974 legislation that made the Postal Service responsible for the pension costs related to salary increases. However, the 1974 language was repealed by Congress.

In addition, the OPM directed the Postal Service to use 100 percent pre-funding for both pension and health care retirement funds. In contrast the OPM has pension funding levels of 41 percent for federal employees and 24 percent for the military. The OPM's own retiree health care prefunding for federal employees is 0 percent. The Standard & Poor's 500 companies' pension funding is 80 percent.

Correcting either the $75 billion overcharge or reducing the 100 percent target pre-funding level to 80 percent would result in the ability of the Postal Service to pay off the Treasury debt associated with paying the $75 billion overcharge. Accordingly, the annual costs and premiums for the health care liability could be financed out of the interest earnings and surplus. Another option for the Postal Service could be to use the $75 billion overcharge to pledge to the retiree health fund instead of making annual payments. This could be done with the agreement of the OPM and the U.S. Treasury. The details concerning each of the three possible solutions can be found in the appendix of the attached Congressional testimony. (See Appendix B pages 13 – 16)

We recommend the Chief Financial Officer & Executive Vice President:

1. Pursue all necessary actions, including those suggested by the Office of Inspector General, to either secure the return of the $75 billion overpayment or to otherwise realize the benefit of this overpayment to the Postal Service.

Management's Comments

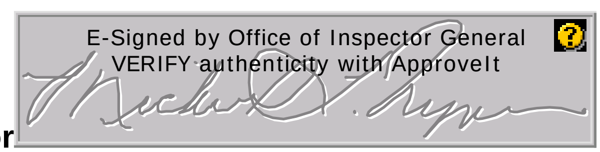
Postal Service management agrees with the OIG's finding that the Postal Service has overfunded its CSRS payments by $75 billion. In addition, they agree with the OIG's recommendation, the monetary impact to the Postal Service, and are pursing various options identified by the OIG to obtain a more equitable CSRS valuation and access to any resulting funds. See Appendix E for management's comments, in their entirety.

Evaluation of Management's Comments

The OIG considers management's comments responsive to the recommendation and management's corrective actions should resolve the issues identified in the report.

The OIG considers the recommendation significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective action(s) are completed. This recommendation should not be closed in the Postal Service's follow-up tracking system until the OIG provides written confirmation that the recommendation can be closed.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information please contact Michael Thompson, director, Capital Investments, or me at 703-248-2100.



for
Mark W. Duda
Deputy Assistant Inspector General
for Support Operations

Attachments

cc: Patrick R. Donahoe
Mary Anne Gibbons
Sally K. Haring

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

In 2003, Congress directed the OPM to use its authority to oversee the reforms using accepted "dynamic assumptions" that include pay increases and inflation. This is the same methodology the OPM currently uses with its other funds including the cost of retiree health care premiums for the Postal Service.

The OPM switched to dynamic funding for the Postal Service portion, but did not for the OPM share. As a result, the Postal Service was overcharged $75 billion for its share of the CSRS pension payments. In essence, for almost 40 years the Postal Service paid all of its and all of the federal government's share of inflationary costs.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this review was to assess the facts concerning the $75 billion overpayment and identify any possible solution(s) to correct the overpayment to the benefit of the Postal Service.

To accomplish this objective we relied on the oral testimony previously given by the Postal Service's IG before Congress on April 15 and 22, 2010, and the written OIG Congressional testimony submitted to the Congress on May 5, 2010. We also relied on the supporting documentation that was used to develop and support the above mentioned testimonies.

We conducted this review from February through June 2010 in accordance with the *Quality Standards for Inspections*.[2] We discussed our observations and conclusions with management officials on June 11, 2010, and included their comments where appropriate.

We did not rely on computer-generated data to support the opinions and conclusions presented in this report.

[2] These standards were last promulgated by the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) in January 2005. Since then, **The Inspector General Act of 1978 as amended by the IG Reform Act of 2008** created the Council of the Inspectors General on Integrity and Efficiency (CIGIE), which combined the PCIE and ECIE. To date, the Quality Standards for Inspections have not been amended to reflect adoption by the CIGIE and, as a result, still reference the PCIE and ECIE.

PRIOR OIG COVERAGE

Report Title	Report Number	Final Report Date	Monetary Impact	Report Results
The Postal Service's Share of CSRS Pension Responsibility	RARC-WP-10-001	January 20, 2010	N/A	The paper demonstrated that the current system of funding the Postal Service's CSRS pension responsibility is inequitable and has resulted in the Postal Service overpaying $75 billion to the pension fund.
Estimates of Postal Service Liability for Retiree Health Care Benefits	ESS-MA-09-001(R)	July 22, 2009	$5.95 billion	The Management Advisory report demonstrated based on OPM's assumptions and methodology, the Postal Service could overfund its retiree health care liability by $13.2 billion by the end of FY 2016.

APPENDIX B: TESTIMONY

Hearing before the Committee on Oversight and Government Reform and the Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia
United States House of Representatives

Written Statement
On
Continuing to Deliver: An Examination of the Postal Service's Current Financial Crisis and its Future Viability

April 15, 2010

David C. Williams
Inspector General
United States Postal Service

Mr. Chairman and members of the Committee, I appreciate the opportunity to submit my written testimony concerning the overcharge of the United States Postal Service (Postal Service) for its Civil Service Retirement System (CSRS) obligations. This issue has a significant impact on the Postal Service's financial viability, its compliance with the Postal Accountability and Enhancement Act (PAEA), and thus its ability to provide world-class universal service to the nation.

On July 1, 1971 the United States Post Office Department (POD), then an agency of the federal government, became the Postal Service, a new self-financing independent government entity. Although the Postal Service is self-financing, it is subject to the Office of Personnel Management (OPM) for health care and pension obligations. The administration of these programs resulted in the Postal Service being overcharged four separate times.

Congress has continually untangled and corrected funding problems:

- In 2002, it was discovered that the Postal Service's pension fund would be overfunded by $78 billion. Congress corrected this in 2003.
- In 2003, the Postal Service was made responsible for $27 billion in military service pension obligations for Postal Service employees. Congress corrected this in 2006.
- In 2009, we found that the OPM used an exaggerated 7 percent health care inflation forecast instead of the 5 percent industry standard, resulting in an

> overpayment of $13.2 billion by 2016. In response Congress urged the Postal Service to coordinate with the OPM and the Office of Management and Budget to develop “a fiscally responsible legislative proposal.”

Lastly, the Postal Service pension fund was overcharged $75 billion, so that employees could retire at promised levels. When the POD became the Postal Service, employees that belonged to the federal pension fund now contributed to the Postal Service. Retirement costs were divided according to the number of years employees had belonged to each fund. However, the federal pension fund paid for retirements based on 1971 salaries, not final salaries. The federal pension fund collected full contributions, but paid only partial benefits.

The OPM has explained that these mischarges were in response to what they believed to be the will of Congress expressed in 1974 legislation. However, the 1974 language was repealed by Congress in 2003, when large overpayments were discovered. At that time the OPM inexplicably had not detected a 41 percent overfunding error in this $190 billion pension fund. Congress directed the OPM to use its authority to oversee the reforms using accepted “dynamic assumptions” that include pay increases and inflation. The OPM switched to dynamic funding for the Postal Service portion, but did not for their share. The Postal Service was forced to pay the $75 billion difference.

In 2009 my office began working with the Hay Group, an actuarial firm, to review the OPM’s CSRS methodology and found that it unfairly burdens the Postal Service:

- In calculating the federal government's share, the OPM methodology assumes that all salary inflation after 1971 should be paid by the Postal Service instead of being divided with the federal pension fund and associated with the respective years of service. This has caused the Postal Service to be overcharged $75 billion for its share of the CSRS pension payments. In essence, for almost 40 years the Postal Service paid all of its and all of the federal government's share of inflationary costs.

- It is instructive that the OPM in this case ignores its own formula which includes final salary and inflationary adjustments for federal and military funds to determine Postal Service pension benefits.

- The OPM methodology of calculating the federal fund's share was constructed using a "freeze frame"[3] approach which allows the federal government to escape the effect of salary increases mostly due to inflation and the growth of the economy on pension costs in violation of accepted accounting practices. It is completely unrealistic to assume employees would receive no pay adjustments for almost a 40-year period, yet the OPM uses just such a methodology in paying its share for former POD employees. This does not comply with the use of dynamic assumptions that the OPM was directed to use in 2003.

- Using the OPM methodology, an employee who worked 15 years for the POD and 15 years for the Postal Service causes the Postal Service to be responsible

[3] To assume former Post Office Department employees retired in 1971 and received no inflationary salary adjustments or the use of a final salary.

for 70 percent of the pension obligation, while the federal funds share would be 30 percent, instead of an even division.

- In 2004 the Postal Service appealed the OPM's methodology and it was denied by OPM. Their denial relied on repealed 1974 legislation that made the Postal Service responsible for the pension costs of salary increases. The new legislation in 2003 directed the OPM to abandon the 1974 legislation and use "dynamic assumptions" that include inflation and pay increases. This is the same methodology the OPM uses with its other funds including the cost of retiree health care premiums for the Postal Service.

- A methodology based on dynamic assumptions — the same methodology the OPM uses to split the cost of retiree health care premiums between the Postal Service and the federal government — would comply with accepted accounting standards. That proposal would finally align the pension and health care methodologies for the OPM.

- Using dynamic assumptions, the federal government and the Postal Service would each be responsible for 50 percent of the pension obligations for an employee who worked half their career for the federal government and half for the Postal Service. The current methodology relies on the Postal Service to pay all of its pension obligations and much of the federal government's share.

Lastly the Postal Service was given a funding target of 100 percent for both pension and health care pre-funding. In contrast the OPM has pension funding premium levels of 41 percent for federal employees and 24 percent for the military. The OPM's own health care prefunding for federal employees is 0 percent. The Standard & Poor's 500 companies' (S&P 500) pension funding is 80 percent.

Correcting either the overcharge or the target pre-funding level would result in the ability to pay off the Treasury debt associated with meeting the overcharges. Annual costs and premiums could be financed out of the interest earnings and surplus. PAEA has a provision to monitor fund levels annually to determine if contributions are adequate to meet target levels.

The vision of the Postal Service in the PAEA was to create a more corporate entity subject to efficient market forces. That cannot be done if the Postal Service continues to be subjected to annual payments of more than $7 billion a year before it enters the market place. Mr. Chairman, I would be hard pressed to name a corporation that could do well in the market place if $7 billion a year were taken from it before it could open its doors for business. The current overcharges of $75 billion have been seen by many in the mailing industry as an unauthorized tax on Americans. Ironically the postal trade press has termed this the "stamp tax."

The mischarges should be backed out and fund balances reset to proper levels to achieve the retirement reforms Congress enacted in 2003. In addition, another option for the Postal Service could be to use the $75 billion to pledge to the retiree health fund instead of making payments. The details concerning the 3 possible solutions can be found in the appendix.

Timely action by Congress and the OPM will provide the Postal Service immediate relief from this financial burden, but it will not wholly close the financial gap. Almost $4 billion will remain to be dealt with by the Postal Service through the reduction of 93 million workhours in FY 2010. Based on the latest projections, the Postal Service is on pace to cut the necessary workhours as they try to meet the loss.

My office would like to elaborate on three alternative solutions to correct the excessive pre-funding levels. Our first solution is designed to correct the OPM's current CSRS pension funding methodology that has overcharged the Postal Service $75 billion from 1972 to 2009. This can be simply fixed by taking the following steps:

- First, the Postal Service's CSRS pension obligations should be calculated using a years-of-service methodology to allow for the return of the $75 billion the Postal Service has already overpaid and going forward.
- Second, $10 billion of the $75 billion CSRS surplus should be used to pay off the Postal Service's Treasury debt, since this debt was incurred making payments to pre-fund retiree health care. This would save the Postal Service over $150 million a year in debt service.
- Third, another $10 billion of the CSRS surplus should be used to pay the total outstanding CSRS pension liabilities, which have increased over its life.
- Fourth, transfer the remaining $55 billion of the CSRS surplus to the retiree health care fund. The $55 billion combined with the already set aside $35 billion will provide a retiree health care fund of $90 billion. The OPM has determined that $87 billion is needed to fully fund the Postal Service's retiree health care liability as of 2009. In addition, under the PAEA any CSRS pension surplus is already scheduled to be transferred to the retiree health care fund at the end of 2015. We propose that the schedule be accelerated so that the transfer occurs immediately.

- Fifth, stop the required payments of more than $5 billion under the PAEA because the account would be funded. This would allow the Postal Service to use the fund for its intended purpose to pay this year's $2 billion retiree premium.
- Most of these simple changes only advance the timing of provisions already in existing law and do not fundamentally alter the funding structure established by the PAEA. The Postal Service's pension and retiree health care obligations would be determined with the same methodology. The Postal Service's pension and retiree health care obligations would be fully funded; unlike the federal government that relies on federal pension funding of 41 percent, military pension funding of 24 percent, federal retiree health benefits at 0 percent and military retiree health benefits at 29 percent.

As I said before, there is no established funding goal. An established goal by Congress of around 80 percent as suggested by the S&P 500 and my office would allow for a second solution to the $75 billion overcharge to the Postal Service for its share of the CSRS pension payments from 1972 to 2009. This solution would be optimal if the $75 billion could not be repaid to the Postal Service. This solution would consist of four parts:

- First, the Postal Service's pension fund obligation would be reduced from 100 percent to about 80 percent. This would make about $52 billion available to the Postal Service.
- Second, $10 billion of the $52 billion should be used to pay off the Postal Service's Treasury debt, since this debt was incurred making payments to

prefund retiree health care. This would save the Postal Service over $150 million a year in debt service.

- Third, transfer the remaining $42 billion to the retiree health care fund to achieve more than an 80 percent funding level.
- Fourth, stop the required payments of more than $5 billion under the PAEA because retiree health care would be funded. This would allow the Postal Service to finally use the funds and its interest income for its intended purpose — paying for retiree health care.

The third solution could be used once the OPM acknowledges the Postal Service's $75 billion overpayment to the CSRS pension fund. This overpayment should not be incorrectly categorized as a "surplus," as the Postal Service is *immediately* entitled to this overpayment. The surplus CSRS funds, on the other hand, are due to the Postal Service on September 30, 2015, and will be comprised of any excess funds that exist once the CSRS pension is fully funded.

An OPM acknowledged $75 billion overpayment becomes an asset of the Postal Service which allows the Postal Service to pledge the excess retiree <u>pension</u> funding to the retiree <u>health</u> fund instead of making payments. The Postal Service can acquire this asset to pledge through the Treasury's issuance of a bond on behalf of the OPM that is payable to the Postal Service. A special Treasury bond, without market value, issued to the Postal Service would allow the Postal Service to pledge this bond (asset), pursuant to 39 C.F.R. § 2005(b) (1) to satisfy its retiree health fund obligations.[4] Under 39 USC 2005(b),

> *"The Postal Service may pledge the assets of the Postal Service and pledge or use its revenues and receipts for the payment of the principal of or interest on obligations issued by the Postal Service under this section, for the purchase or redemption thereof, and for other purposes incidental thereto, including creation of reserve, sinking and other funds which may be similarly pledged and used, to such extent and in such manner as it deems necessary or desirable…."*

The $75 billion Treasury bond, at some undetermined time in the future, would result in a transfer of actual funds to the retiree health fund obligations. This transfer could be coordinated with the PAEA mandated 2015 transfer of funds between the retiree pension fund and the retiree health fund.

[4] The issuance of an interagency debt instrument is exemplified by the arrangement between the Social Security Administration (SSA) and the Treasury.

- The surplus SSA tax revenues are maintained in a SSA Trust Fund which, like the Postal Service Fund, is an off-budget fund.
- Because the Treasury had spent SSA's tax-generated revenues, it has since provided SSA with $2.5 trillion in special-issue Treasury bonds that SSA may redeem, as necessary, when its annual tax revenues no longer cover its disbursements.
- This fiscal year, SSA will begin redeeming some of its Treasury bonds.

APPENDIX C: MONETARY IMPACT

Monetary Impact of Returning $75 billion to the Postal Service

($ Millions)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
PAEA Required Pre-Funding Payments Eliminated	$5,500	$5,500	$5,600	$5,600	$5,700	$5,700	$5,800
Current Retiree Health Benefit Premium Payments Eliminated	2,300	2,600	2,900	3,300	3,600	4,000	4,500
Total Payments Eliminated	**$7,800**	**$8,100**	**$8,500**	**$8,900**	**$9,300**	**$9,700**	**$10,300**
Savings Discounted at Postal Service Cost of Borrowing (3.875%)	$7,800	$7,798	$7,878	$7,941	$7,988	$8,021	$8,199
Net Present Value of Savings	$55,624						
Net Present Value of Savings, OIG Project 09RO013ESS000	(5,816)						
Net Monetary Impact	**$49,808**						

The net present value of the expected future savings, which would result from crediting to Postal Service $75 billion in CSRS pension fund overpayments, is $55.624 billion. OIG is claiming $49.808 billion in monetary impact for this project. The difference between these two numbers is $5.816 billion, which is the amount we had already claimed in FY 2009 (Project Number 09RO013ESS000), for the period 2010-2019, for essentially the same subject matter. The OIG subtracted this amount from the savings calculation for this current project in order to avoid double-counting monetary impact claims.

APPENDIX D: ANALYSIS OF INTEREST EARNED

Postal Service Retiree Health Benefits Fund (PSRHBF)
Interest Earned and Payments 2010 – 2016

($ Millions)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
PSRHBF Balance	$90,000	$91,750	$93,279	$94,576	$95,532	$96,231	$96,562
PSRHBF Interest Earned at 4.5 Percent	4,050	4,129	4,198	4,256	4,299	4,330	4,345
PSRHBF Payment	2,300	2,600	2,900	3,300	3,600	4,000	4,500
PSRHBF Net Change	**$91,750**	**$93,279**	**$94,576**	**$95,532**	**$96,231**	**$96,562**	**$96,407**

FY 2010 fund balance at $90 billion supposes an additional $55 billion is added to the current fund balance of $35 billion.

Interest rate of 4.5 percent is based on the 2009 rate and assumes no increase in interest rates.

Payments are funded by interest income until FY 2016 when the premium exceeds interest earned by approximately $155 million. This could be paid by using fund principal or as a Postal Service supplement.

The premium payment is based on current projection without any change. The premium payment projection is recomputed each year.

APPENDIX E: MANAGEMENT'S COMMENTS

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER
EXECUTIVE VICE PRESIDENT

UNITED STATES POSTAL SERVICE

June 17, 2010

MS. LUCINE WILLIS

SUBJECT: Audit Report—Civil Service Retirement System (CSRS) Overpayment by the United States Postal Service (OIG Report Number CI-MA-10-DRAFT)

Thank you for the opportunity to respond to the above referenced report. United States Postal Service management agrees with the position of the Office of Inspector General (OIG) that the Postal Service has over-funded its Civil Service Retirement System (CSRS) obligations by $75 billion through September 2009. This situation has resulted from the inequitable methodology used to apportion the retirement obligations between the Post Office Department (POD) and the Postal Service.

OIG's Recommendation
The OIG's report recommends that the Chief Financial Officer & Executive Vice President of the Postal Service pursue all necessary actions, including those suggested by the OIG in its Appendix C, to either secure the return of the $75 billion overpayment or to otherwise realize the benefit of this overpayment to the Postal Service.

Response
The Postal Service's Government Relations team is currently pursuing a number of approaches, similar to those proposed by the OIG, to obtain a more equitable CSRS valuation and access to any resulting surplus funds.

We do not believe that this report or management's response contain information that may be exempt from disclosure under the Freedom of Information Act.

Joseph Corbett

cc: Ms. Dominguez
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